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AGENDA ITEM 6

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Revision of Policy on Supplemental Income Plans
- II. PROGRAM:** Supplemental Income Plans
- III. RECOMMENDATION:** Recommend to the Investment Committee approval of the revised Statement of Investment Policy on Supplemental Income Plans (Attachment 1)

(Please refer to Attachment 2 for Wilshire's opinion letter.)

IV. ANALYSIS:

Background

In November, the CalPERS Supplemental Income Plans (SIP) completed a phased three-year process to convert its investment offerings to CalPERS funds managed by internal investment staff and separate accounts managed for CalPERS by select external managers. Previously, the SIP investment fund line-up consisted of several externally managed funds, including commingled bank funds. The commingled bank funds' policies often contained frequent trading restrictions that would limit the trading by participants in the fund. These restrictions allowed the fund managers to address individual participant practices that occur at the expense of other participants in the fund. Because the externally managed commingled funds have been replaced by CalPERS internally managed funds and externally managed separate accounts not subject to the commingled fund trading restrictions, staff recommends establishing its own policy regarding frequent trading for both internally and externally managed funds in the SIP fund line-up.

Although frequent trading is not per se an illegal practice, it can have an adverse impact on the fund and many funds impose limitations to mitigate against this practice. For instance, in the mutual fund industry, many mutual funds maintain policies discouraging frequent or disruptive trading because mutual funds, like other collective investment funds, are not generally designed to serve as frequent-trading vehicles. Mutual funds generally calculate the net asset value (NAV) per share using the most recent transaction prices at the close of U.S. equity markets (4 PM Eastern Time (ET)). Investors are allowed to place trades up until that time. In some cases, however, the closing price of a security held in a mutual fund's portfolio may not reflect its actual market value at the time of the fund's NAV calculation.

Funds that invest in overseas securities markets are particularly vulnerable to market timers who may take advantage of time zone differences between the close of foreign markets on which international funds' portfolio securities trade and the close of U.S. markets when the transactions must be priced ("time-zone arbitrage"). Market timing opportunities, however, are not limited to international funds. Funds that invest in small-capitalization equity securities and other types of investments which are not frequently traded may also become the targets of market timers.

Discussion

Similar to mutual funds, the SIP funds allow participants who self-direct their investments to redeem their shares on each business day and receive their pro rata share of the funds' net assets in a distribution, if eligible, or a transfer of assets to other investments. This redemption right makes the funds attractive to plan participants because it provides ready access to their money to make investment changes, rebalance or reallocate their portfolios, or transfer between funds as market conditions and their personal retirement savings goals warrant. The redemption right, without any limitations, allows a small group of participants who use the funds to implement short-term trading strategies such as market timing, to make frequent purchases and redemptions in order to capture small gains. Most SIP fund participants, however, are not active traders of their shares in the funds.

Market timing or active trading of the SIP funds is not prohibited under the SIP administrative rules of the funds. However, excessive short-term trading can negatively affect other participants in the fund. At times when fund shares may not be accurately priced relative to the market, short-term traders have an arbitrage opportunity that they can use to exploit the fund and disadvantage the fund's long-term investors by extracting value from the fund. This dilutes the value of other participants' shares because the short-term gains achieved by market timers are losses to the fund.

Additionally, excessive short-term trading can disrupt management of the fund's investment portfolio by increasing the need for managers to hold larger cash positions, or to force the sale of securities at inopportune times in order to accommodate the market timers' frequent trades in and out of the fund. This, combined with the added trading costs associated with the frequent buying and selling of shares, could adversely affect the fund performance and the fund's ability to track its benchmark. Excessive short-term trading therefore occurs at the expense of long-term investors by diluting the value of their shares, increasing fund costs and eroding long-term fund performance, and is contrary to the SIP's design of funds as long-term retirement investments.

While it is important to preserve the ability of individual participants in the SIP to self-direct their investments, including the ability to transfer between funds, rebalance their portfolios and redeem shares in order to take distributions, it is equally important that individual participants bear responsibility for the costs and repercussions of their actions without unfairly burdening other participants.

To date, the SIP funds have experienced some short-term trading by several individual participants. Given the small value of these individuals' trades, the fund losses have been small compared to the overall value of the funds. However, to prevent significant losses should a large number of participants start short-term trading, staff is proposing this policy for all SIP funds, both internally and externally managed.

Staff recommends establishing a frequent trading policy to achieve a balance between the right of individual participants to exercise control over the assets in their accounts, and the right of all participants to enjoy appropriate growth of their assets in proportion to the risk they bear and at reasonable cost through investment in prudently managed investment funds. The recommended SIP policy changes are in Attachment 1. This policy is consistent with industry best practices to protect the value of the funds for all who participate. The policy itself provides for:

- identifying frequent trading,
- participant notification processes and
- restricting excessive trading.

V. STRATEGIC PLAN:

This item supports:

Goal (V), by providing sustainable pension benefit products and services responsive to and valued by members, employers, and stakeholders, and

Goal (VI) to Administer pension benefit services in a customer oriented and cost effective manner.

VI. RESULTS/COSTS:

There will be unspecified administrative costs to monitor participant trading activity for SIP and the Third Party Administrator (TPA) staff. The TPA is experienced in implementing short-term trading restrictions and is prepared to implement this policy.

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